

The Financial Crisis and Corporate Governance

May 26, 2009

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Corporate governance, according to Professor Franklin Allen of the Wharton School at the University of Pennsylvania, is one of the least-understood factors that also played a role in the economic crisis. In a recent RIETI presentation, Professor Allen gave a brief, yet very thorough history of the crisis and the causes behind it, pointing out both the common culprits and some of the lesser-known contributors, such as various corporate governance practices.

Conventional wisdom says that the crisis was caused by bad incentives in the mortgage industry. The change to the “originate and distribute” model in the last decade led to the securitization of mortgages. As time progressed, investment banks and other sponsoring entities sold off all tranches of securitizations, effectively relieving themselves of any incentives to oversee the mortgage practice and make sure that originators were properly screening mortgage candidates. However, the severity of the real effects of the crisis can be seen even in countries with relatively healthy banking systems. Today, more people recognize that the subprime mortgage problem was more of a symptom than a cause.

Where the crisis began

The main problem was a bubble, first with stock prices and

then property prices. The monetary policies of central banks were much too loose. In the United States, low interest rates and tax incentives made mortgages more attractive than renting. This system caused home prices to increase more than inflation and even interest rate increases could not stymie the home-buying boom. This, however, does not provide a complete explanation because many other countries had price bubbles.

Global imbalances were another factor. In the Asian Financial Crisis of 1997, strong Asian economies like Thailand and South Korea got into trouble because they borrowed too much in foreign currency. After the IMF imposed higher interest rates and lower government expenditures on these Asian economies, Asian countries began amassing large reserves in their central banks. Asian economies found that it was difficult to invest these funds in anything but debt securities. This contributed to the surplus of funds worldwide, making it easier for people around the world to borrow money.

The huge GDP drops seen around the world can be explained by the fact that people, particularly in the U.S., made decisions based on the wrong asset prices for more than a decade. People in the U.S. concluded that since stock and housing prices would continue to increase, having a stock portfolio and a home would negate the need to save. The savings rate in the U.S. dropped to zero as a result. When the bubble burst, assets that people were depending upon to see them through old age were no longer sufficient.

🌐 Failures of the banking system

But why has the heavily regulated financial sector performed so badly? Bank regulation comes with certain costs and benefits. Benefits include stopping banking crises, as the lack of banking crises for the first 20 years of the post-war period attests to. Heavy regulations shielding banks from risk came to be regarded as a hindrance that kept the banking system from performing its basic task of allocating resources across different industries and playing the invisible hand of the market. From the 1970s onward, financial liberalization took place and crises soon returned.

There are three primary failures of the banking system. The first is inefficient liquidity provision. Private markets do not do a good job of providing liquidity because holding liquidity is costly. Central banks then scramble to provide liquidity with various ill-designed plans and thus exacerbate the problem. The second is mispricing assets. The basic concept of people stepping in to drive prices up or down depending on whether they are under or overpriced has broken down. Prices of triple-A rated tranches fell and investment banks doubled-up on them, which caused drops in prices and bigger losses. Such tranches' prices are still not known for sure.

The third and most serious market failure is contagion. Contagion is represented by the Fed stepping in to help J.P. Morgan buy Bear Stearns. It was thought that Bear Stearns' bankruptcy would have created a domino effect of bankruptcies due to how connected Bear Stearns was with so many other firms. The Fed did not want to take that risk and decided to save it. When Lehman Brothers failed, the government believed that there was no contagion risk. However, the Lehman failure ended up causing huge ripples in the economy because contagion was more complex than previously thought.

Central banks and governments hold too much to old views of what the crisis is about. There is a problem in believing that the crisis is primarily a problem of the banking system. The government is not doing the right thing by initially purchasing preferred stock and thus providing a de facto debt guarantee. The government has no control and the banks know they have a blank check to do what they want. The government needs to temporarily nationalize large banks like Citigroup and Bank of America, and then break them up and sell them off.

The real problem of the bubble bursting is that price adjustment takes a long time. It could take between two

and three years for prices to adjust completely in the U.S. Current government policies will have little effect on this problem and may, in fact, exacerbate it.

🌐 Corporate governance

One factor that has not received much attention in the crisis but is very important for macroeconomic stability is corporate governance. Japan and Germany have had large GDP drops but their unemployment rates have been affected much less than other countries. Unemployment in the U.S. has increased steadily while Germany has increased nominally and Japan has remained relatively stable. The fear of unemployment in the U.S. causes people to reduce spending and save more, though fear of unemployment is not as much of a problem in France, Germany and Japan. One explanation of these differing employment trends is variations in corporate governance.

The Anglo-Saxon system of firing people and pursuing shareholder interests is a great system when times are good. Throughout the 1990s in the U.S. it was a great system for reallocating resources. However, in bad times it is very good to have a stakeholder system. Globalization has led to the U.S. becoming a dumping ground for foreign firms' employment reduction efforts. A full evaluation of stakeholder governance is needed in order to further promote it.

Question & Answer Session

- ▶ **Q.** You listed the main causes of the financial crisis as the burst of the bubble. However, this is not the first bubble to burst in the U.S. There were bubbles bursting in the 1980s and 1990s. Why couldn't the U.S. learn from the mistakes it made in past bubbles?
- ▶ **A.** What is different in the U.S. is that it has not had a truly nationwide fall in property prices since the Great Depression. The Asian experience was never looked at to evaluate mortgage securities. Most Asian countries have had property price bubbles at some point in the last 20-30 years. The U.S. did not think it could happen and did not consider it a danger at all. Bubbles in the stock market are very different and do not do nearly as much damage as property bubbles because the way people hold equities is different from how people hold debt securities due to the fixed promises they represent in the financial system. Usually equity securities are not held against fixed promises, which is the big difference.